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RUEKJCS/SECDEF WASHINGTON DC
RUEHRC/DEPT OF AGRICULTURE WASHDC
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RUEHKP/AMCONSUL KARACHI 1157
RUEHPW/AMCONSUL PESHAWAR 5768

UNCLAS ISLAMABAD 000440

SIPDIS
SENSITIVE

E.O. 12958: N/A
TAGS: EFIN ECON EINV EAID PGOV PREL PK
SUBJECT: PAKISTAN MEETS FUND TARGETS; MORE LEEWAY AS GROWTH SLOWS

REF: A. Islamabad 0238
¶B. Islamabad 0315

¶1. (SBU) Summary. The IMF finished its first "generally positive" review of Pakistan's Standby Arrangement on February 25. While the program remains on track, the Fund has relaxed its fiscal deficit and tax revenue targets slightly, based on a deteriorating global economic environment. Finance Advisor Tarin said that the IMF had predicted GDP growth at 2.5 percent, down from 3.5 percent. The Fund's press release emphasized the necessity for additional external budget assistance. End Summary.

¶2. (SBU) The International Monetary Fund (IMF) concluded its first review under Pakistan's Stand-By Arrangement, along with its 2009 Article IV consultations, on February 25, after 12 days of meetings in Islamabad and Dubai. In a press statement, the IMF said the program remains on track, characterizing initial developments as "generally positive." The Fund was impressed by the GOP's "strong resolve" to sustain prudent macroeconomic policies. Pakistan met all of the program's quantitative performance criteria for end-December 2008, an outcome that had been widely anticipated (Ref A).

¶3. (SBU) The exchange rate has remained broadly stable and Pakistan's international reserves position has strengthened significantly, with the State Bank's gross reserves exceeding $6.8 billion at the end of January. The Fund's statement said that structural reforms have proceeded broadly as envisaged. A contingency plan for handling problem banks has been prepared and is being strengthened, and an action plan to reform tax policy and administration has been adopted and will be implemented with technical assistance from the Fund and the World Bank. The GOP reiterated its commitment to end electricity subsidies by June (by phasing in a one percent increase monthly from March through June) and a plan has been designed to address the circular debt issue (Ref B).

¶4. (SBU) The IMF agreed that the GOP can reduce interest rates as inflation decreases. "The authorities and the IMF team agreed that the current monetary policy stance was appropriate and will continue to promote domestic and external stability. If both headline and core inflation decline, there should be scope for lower rates, provided that the international reserves position continues to improve and the government avoids resorting to SBP financing." The IMF Res Rep told us in early February that inflation was proving

unexpectedly stubborn, in spite of falling global food and oil prices.

¶5. (SBU) Finance Ministry officials confirmed that the IMF had scaled down Pakistan's growth rate from 3.5 to 2.5 percent, and had reduced its tax revenue target to Rs. 1.3 trillion. As a result the fiscal deficit target will increase slightly from 4.2 to 4.3 percent of GDP, with a fiscal gap of Rs. 562 billion. The Fund has revised its estimate of the current account deficit, from 6.5 to 5.6 percent of GDP, as the rate of import growth (-14.5 percent) is expected to decline more than the growth rate of exports (-5.5 percent).

¶5. (SBU) Comment: The IMF Resident Representative (protect) predicted privately in early February that Pakistan's GDP growth rate might approach negative two percent this fiscal year. With a fast growing working-age population and a large number of poor, an economic slow-down will hit the country hard. This makes it even more important that the GOP effectively structure its social safety net programs to target the most vulnerable segments of the population. Generous external financial assistance provided at the upcoming donors' conference is also crucial, a fact that the IMF has emphasized in its public and private statements, although it has made clear that direct budgetary assistance would be preferable.

FEIERSTEIN